

# Israel Free Trade Area Pre-Assessment Survey

## Internal Control Technical Guide

### Objective

Provide guidance in performing a Pre-Assessment Survey (PAS) of the company's internal control for goods entered for preferential treatment as products of the Israel Free Trade Area (IFTA) and evaluating the results.

### Background

Generally Accepted Government Auditing Standards require the PAS team to obtain a sufficient understanding of internal control to plan the audit and determine the nature, timing, and extent of tests to be performed.

The guidelines and terms in this technical guide are based on *Assessing Internal Controls in Performance Audits*, GAO/OP-4.1.4, in Performance Audits published by the United States General Accounting Office, Office of Policy, September 1990; and the American Institute of Certified Public Accountant's *Statement on Auditing Standards No. 78*.

On April 22, 1985, a free trade agreement was established between the Government of the United States of America and the Government of Israel. Public Law 99-47 entitled the U.S.-Israel Free Trade Area Implementation Act of 1985. IFTA is a special trade program authorized by the president to extend trade benefits for eligible articles of Israel for preferential treatment when entered into the U.S. and satisfying the IFTA eligibility requirements. The eligibility requirements for IFTA goods are found in General Notes (GN) 8 and 3(a)(v) of the Harmonized Tariff Schedule of the United States (HTSUS). The GN describes specific rules that are considered for IFTA preference.

GN 8 designates articles produced by Israel and GN 3(a)(v) covers specific entities including the West Bank, the Gaza Strip or a qualifying industrial zone (defined in GN 3(a)(v)(G)) as eligible to claim preference under IFTA.

Merchandise subject to IFTA preference appears in the HTSUS as "Free" in the HTSUS "Special" Rate of Duty subcolumn followed by the symbol "IL" in parenthesis. The Israel Free Trade preference is claimed on the imported good by using the symbol "IL" in the Special Program Indicator field of the Automated Commercial System (ACS) database.

Although GN 8(e) indicates regulations will be issued as necessary, to date there are no formal regulations for the IFTA.

To qualify for preferential treatment merchandise of the IFTA must:

- Be imported to the U.S. directly from Israel, the West Bank, the Gaza Strip or a "qualifying industrial zone". The direct shipment requirements are in GN 8(b)(ii) and 3(a)(v)(B).
- Meet the country of origin criteria and either: a) be merchandise wholly the growth, product or manufacture of Israel, the West Bank, the Gaza Strip or a "qualifying industrial zone"; or b) be merchandise transformed into a new or different article that has been grown, produced or manufactured in Israel, the West Bank, the Gaza Strip or a "qualifying industrial zone". The origin criteria are stated in GN 8(b)(i) and 3(a)(v)(A)(1) & (2).

- Meet the value content requirements where the sum of materials and direct cost of processing must represent not less than 35 percent of the goods' appraised value at the time it is entered. If the article includes cost or value of materials produced in the customs territory of the United States, an amount not to exceed 15 percent of the appraised value may be applied toward determining the percentage. The percentage value content requirements are stated in GN 8(b)(iii) and 3(a)(v)(A)(2).

The term "Qualifying Industrial Zone" is a term defined in GN 3(a)(v)(G) as "any (designated) area that encompasses portions of the territory of Israel and Jordan, or Israel and Egypt."

Additional guidance may be found in:

- C.S.D. 85-25 (double substantial transformation);
- Ruling 556193, dated 12/23/91 (dual-sourcing);
- Ruling 557087, dated 7/22/93, T.D. 81-282, T.D. 78-399, and C.S.D. 80-208 (unallowable general and administrative costs); and
- Ruling 559010, dated 3/14/96 and T.D. 91-7 (treatment of components in sets).

## Examples of Red Flags

The following examples are conditions that may indicate a potential problem with IFTA merchandise.

- Company has insufficiently documented, poorly defined, or no internal control for accurately declaring merchandise entered as products of IFTA for Customs purposes.  
Examples:
  - ✓ Company does not monitor or interact with the broker on IFTA issues.
  - ✓ Company relies on one employee to handle IFTA issues, and there are poor or no management checks or balances over this employee.
- Responsible person lacks cost accounting knowledge.
- Company's import staff lacks knowledge of IFTA eligibility requirements.
- Company offers unreasonable explanations to Customs.
- Company fails to cooperate with or respond to Customs.
- Company has high turnover of people in key positions.
- Significant variance exists between the importer's data and Customs' data.
- Customs (import specialist, account manager, compliance measurement, prior audit) shows history of problems with merchandise entered as IFTA goods.
- One company representative dominates multiple phases of the IFTA process without monitoring or management oversight.
- HTSUS numbers that the company uses to enter IFTA merchandise have high compliance measurement error rates.
- Company imports from a specific exporter, or under an HTSUS number or country of origin, that have been identified by Customs because of known or suspected IFTA problems.
- Company has a large number of IFTA exporters or a large number of goods for which IFTA is claimed.
- The company does not request, maintain, or review documents supporting the qualification of IFTA imports.
- Company has a sharp increase of IFTA imports from a prior period.
- The importer claiming IFTA and the exporter producing the merchandise are related parties.

- There have been no prior audits or Customs reviews of IFTA imports.
- The profile identifies specific IFTA issues.
- The IFTA producer dual sources or obtains a material from two different countries, where only one material is a product of Israel.
- The merchandise does not have required markings to distinguish the origin.
- A declaration that assembled IFTA goods declared as wholly produced or manufactured in Israel or a “qualifying industrial zone” appears to be doubtful.
- The importer does not request, maintain, or review documents supporting the qualification of IFTA imports (e.g., value content requirements).
- Value content qualification is marginal, just meeting the 35 percent requirement, increasing the importance of accurate cost computations.
- Direct materials alone are not adequate to meet the 35 percent value content requirement, making accurate direct processing costs particularly important.
- Textiles and apparel articles imported are subject to textile restrictions.
- Amounts on cost sheets for unallowable general expenses and profit appear unusually low, indicating that allowable costs may be overstated.

### **Examples of Best Practices**

- Internal controls over merchandise entered for preferential treatment under the Israel Free Trade Act (IFTA):
  - ✓ Are in writing;
  - ✓ Include procedures for monitoring and feedback; and
  - ✓ Were monitored by management.
- One manager is ultimately responsible for control of the import department, including merchandise entered as IFTA goods. That manager has knowledge of Customs matters and the power to assure internal control procedures for imports are established and followed by all company departments.
- Written internal control procedures assign IFTA duties and tasks to a position rather than a person.
- The company has good interdepartmental communication regarding IFTA matters.
- The company conducts and documents periodic reviews of IFTA merchandise and uses the results to make corrections to past and present entries, and makes changes to their import operations as appropriate.
- Purchasing, Engineering, other departments, and suppliers provide sufficient descriptions of merchandise to permit a determination of IFTA eligibility.
- Internal control involves a verification process to determine that the imported merchandise qualifies for IFTA.
- Importer has procedures to obtain any required or necessary documentation to support the claim (e.g. a penalty provision on the supplier if IFTA information is not provided to Customs on demand).
- Importer maintains a database or listing of imported merchandise that would readily identify IFTA transactions.
- The importer (or the importer’s agent) visits the plant in the IFTA country where the products are produced.
- The importer performs an annual review of changes to IFTA.

## Examples of Documents and Information to Review

- Internal control policies and procedures for ensuring IFTA eligibility.
- The company's response to the questionnaire.
- Interviews with company staff concerning actual procedures and controls specific to IFTA imports.
- Documentation that supports monitoring and verification of established and/or written internal control for IFTA imports.
- The company's documentation that supports monitoring and verification of established and written internal control for IFTA including:
  - ✓ An IFTA declaration signed by the person responsible for certifying that all information on the documentation is accurate and complete,
  - ✓ A list of goods by vendor that are products of the IFTA,
  - ✓ Invoices, specification sheets, or other documents providing a detailed description and origin of the IFTA goods,
  - ✓ Bills of Lading or other documents that show direct transport to the U.S.
  - ✓ For related or unrelated foreign vendors, bills of material listing country of origin of the materials used in production of the good,
  - ✓ Travel documents that show that the company has recently visited the IFTA manufacturer and verified the commodities are manufactured, produced, or wholly grown in Israel, the West Bank, the Gaza Strip or a "qualifying industrial zone",
  - ✓ Records from the IFTA producer supporting the company's verification for goods not wholly the growth or product of Israel, such as, cost allocation worksheets, bills of materials, product specification sheets, engineering drawings, work-in-process documents, material inventory records, purchase history reports, and/or material supplier lists,
  - ✓ Country of origin markings on products and components,
  - ✓ Manufacturer's affidavits as to country of origin of components,
  - ✓ "Where used" reports ("exploded" bills of material) showing that components underwent "double substantial transformation," and
  - ✓ Accounting records supporting product cost sheets, including financial statements, post-closing trial balance, detailed chart of accounts, and general ledger detail.

## Suggested Testing

PAS team judgement should be used to determine the type and amount of testing needed to evaluate how effective internal control is and to determine whether there is a sufficient risk to warrant proceeding to Assessment Compliance Testing (ACT) phase.

Using the chart and the guidelines below, determine through limited judgmental testing whether the company's internal control is effective.

To determine the extensiveness of internal control testing, it is necessary to evaluate:

1. The **risk exposure level**, and
2. The **internal control** system by determining if the controls are in operation, how the controls were applied, how consistently they were applied, and who applied them.

## Risk Exposure

Risk exposure is the probability of significant Customs noncompliance. In each step of determining risk exposure, consideration should be given to:

1. Significance (to Customs) and sensitivity (e.g., issues of interest to Congress or the media, or affecting admissibility).
2. Susceptibility (of making incorrect declarations).
3. The existence of any “red flags.”
4. Management support (of strong internal control).
5. Competent personnel (to adequately administer the controls).

*Steps to Determine Risk Exposure:*

1. Evaluate problems identified in the profile, compliance measurement rates, questionnaire, and concerns raised by the import specialist and account manager.
2. Perform the macro risk analysis tests.
3. Analyze the macro risk analysis tests results to determine the risk exposure level.
4. Evaluation of risk exposure is not simply a one-time process that occurs at the start of the PAS process. Continually reassess risk exposure as more information is gathered from evaluating internal control and performing other work in the PAS.

**Macro Risk Analysis Examples**

*Example A: Low Risk Exposure*

The import specialist did not identify specific concerns with this importer's IFTA program. There are no inconsistencies in information regarding the IFTA program in the importer's responses in the questionnaire. The importer had no history of high compliance measurement error rates. The PAS team compared the total IFTA merchandise value to the value reported in ACS and determined the variance with importer records to be insignificant. The materials used to produce the merchandise, claimed under the IFTA provisions, were materials known to be grown, produced, or manufactured in Israel, the Gaza Strip, the West Bank, or a qualifying industrial zone. The goods were directly shipped from Israel to the U.S. Because there were no PAS team concerns and the importer's import data mirrored Customs ACS data, the risk exposure for inaccurate claim of IFTA was considered low.

*Example B: High Risk Exposure*

The import specialist identified specific concerns with this importer's IFTA program. Some of the IFTA manufactured goods were reported as wholly the growth, production, and manufacture of Israel. The good was made from numerous components and some have foreign markings. Therefore, it's unlikely that the goods were wholly grown, produced, and manufactured in Israel. In addition, the importer had high turnover in the import department and it appeared that no one was familiar with IFTA. Because of the PAS team's concerns and the discrepancy between the importer declaration and the markings, the risk exposure level was considered high.

## System of Internal Control

To evaluate the internal control system:

1. Consider the five components of internal control:
  - Control Environment
  - Risk Assessment
  - Control Activities
  - Information and Communication
  - Monitoring
2. Review relevant Customs and company documents to identify and understand relevant internal control over entries of IFTA products (examples of documents and information to review are listed on prior pages).
3. Determine whether the company established and follows procedures by reviewing:
  - Documentary evidence of the results of periodic internal control reviews/testing and corrective action implemented.
  - Documentary evidence (such as a log) of communication between the broker and the company on IFTA issues, including company testing of broker operations and verification that the broker followed company instructions.
  - Company-specific IFTA rulings, and evidence that they are followed.
  - Documentary evidence of intra-company communications to ensure correct information is provided to Customs.
  - Training records and materials relating to IFTA used to educate staff on Customs matters.
4. Review written policies and procedures and interview applicable company personnel to complete appropriate sections of the "Worksheet for Evaluating Internal Control over IFTA Goods".

Note: The internal control assessment should include steps to:

- Identify and understand internal control.
- Determine what is already known about control effectiveness.
- Assess the adequacy of internal control design.
- Determine whether controls are implemented and effective.
- Determine whether transaction processes are documented.

## Extensiveness of Audit Tests (Testing Limit)

The purpose of limited PAS testing is to take a survey in order to determine the necessity for and extent of substantive tests. In some circumstances, the PAS team may decide that it probably will not be able to form an opinion based on limited PAS testing. In that case, it may be necessary to proceed immediately to the ACT process. If the PAS team believes that it can form an opinion based on limited PAS testing, test the appropriate number of controls and associated

transactions using the table below. Tests may be appropriate for various areas below the total IFTA level that compliance will be reported on. For example, the company may import from several foreign companies, but testing may be necessary only for certain companies or certain products that have been identified as primary risks.

### Determine Extensiveness of Audit Tests

<b>Risk Exposure</b>	<b>+</b>	<b>Preliminary Review Internal Control</b>	<b>=</b>	<b>Extensiveness of Audit Test</b>	<b>Testing Limit</b>
<b>High</b>		Weak Adequate Strong		High Moderate to High Low to Moderate	10-20
<b>Moderate</b>		Weak Adequate Strong		Moderate to High Moderate Low	5-15
<b>Low</b>		Weak Adequate Strong		Low to Moderate Low Very Low	1-10

Source: Adapted from *Assessing Internal Controls in Performance Audits*.

Column titled "Testing Limit" reflects Customs test sizes.

### Evaluation of Pre-Assessment Survey Testing Results

The following steps are guidance for determining the effectiveness of company's internal control over merchandise entered as products of IFTA.

1. Complete the "Worksheet for Evaluating Internal Control Over IFTA Goods" to determine whether risk determination is acceptable or unacceptable and to document why. Put results of testing in perspective and evaluate confirmed weakness as a whole. The evaluation should consider the results of the internal control testing, problems identified in the profile, and/or concerns raised by the import specialist or account manager. The team must evaluate the PAS results based on the specific situations.

Customs considers risk unacceptable when testing reveals that internal control is not sufficient or effective in providing reasonable assurance that accurate, timely, and complete declarations are reported to Customs.

2. The following will help the PAS team determine whether conditions warrant proceeding to ACT.
  - **Do not proceed to ACT (Revenue) if:**
    - ✓ Cost benefit analysis warrants no further effort (do not spend a significant amount of resources to identify a potential loss of revenue considered insignificant).
    - ✓ The PAS indicated that the IFTA revenue loss was due to an isolated incident.
    - ✓ The company agrees with PAS finding(s) and agrees to quantify the loss of revenue within an acceptable timeframe.
  - **Do not proceed to ACT (Compliance) if:**
    - ✓ Error was isolated and the importer can show identical entry lines are correct.

- ✓ The errors were systemic and the importer agreed to develop and implement a compliance improvement plan within an acceptable timeframe.
- **Proceed to ACT (Revenue) if:**
  - ✓ The company does not have adequate internal control, and PAS indicates a material loss of revenue that cannot be quantified without statistical sampling or further review.
  - ✓ Importer will not quantify loss of revenue.
- **Proceed to ACT (Compliance) if:**
  - ✓ The company refuses to take corrective action on systemic errors and it is necessary to calculate a compliance rate.

Note: If substantive tests necessary to determine a compliance rate, or revenue loss, can be performed quickly and without extensive effort, the team should immediately perform the substantive tests without proceeding to ACT.

3. Determine whether EET thresholds are met, or could be met, and take appropriate action.

### Examples

The following examples of situations that might be encountered under the PAS are *for clarification only*.

#### *Example A: Situation in which the team would not proceed to ACT (Revenue)*

##### Background

Commodities Inc., (CI) imports a number of articles manufactured in Israel (none are wholly a product of Israel) entered duty free. The exporter has indicated that the IFTA merchandise is produced with materials obtained from both the United States and foreign vendors. The internal control procedures listed in CI procedure manual requires that two conditions be met before purchasing. The two conditions are: 1) the buyer must secure from the IFTA vendor, at the time the purchase order is written, a general written statement regarding the content of the merchandise; and 2) the purchasing department will obtain from the vendor, as part of the purchase order, a statement that the vendor will provide Customs with detailed value content data on demand. The purchase order statement also indicates any failure to supply Customs with the needed content information will make the IFTA vendor liable for any duty due.

The PAS team requested the IFTA vendors' material costs and allocation of direct costs of processing for eight items. The eight items represented imports from all IFTA vendors and 90 percent of the IFTA merchandise value. The producers were able to provide the requested information because of the conditions set in the purchase orders. An analysis of how the producers allocated the labor and overhead costs revealed that the allocations included some costs that were not part of the direct cost of processing. As a result of the revised allocations, one item failed to meet the 35 percent content requirements.

CI agreed with the PAS finding and quantified the loss of revenue. CI also reviewed the remaining 10 percent of the IFTA merchandise not covered by the PAS and found that they qualified for IFTA treatment. The PAS Team reviewed CI's work and confirmed its accuracy. Therefore, proceeding to ACT was not considered necessary.



*Example B: Situation in which the team would not proceed to ACT (Compliance).*

Same as Example A above except that the purchase order for one item did not have the IFTA “documents on demand/duty for failure to provide records” provision stated on the purchase order. Although the purchase order procedure was not followed, the article was entered under IFTA preference. The company found that despite their failure to put the provisions on the purchase order, the content information was supplied to Customs on demand and the good was determined to qualify under the IFTA.

The cause for the above error was the lack of communication between departments and internal control procedures in place at the time. The company established a CIP to reinforce existing procedures and to improve communication between the departments. Therefore, proceeding to ACT was not considered necessary.

*Example C: Situation in which the team would proceed to ACT (Revenue).*

Same internal control procedures as in Example A, except that 16 items (two from each vendor) were selected from eight vendors for review. The PAS sample represented 52 percent of the IFTA entered value and eight of the 10 IFTA vendors.

Two of the eight vendors tested failed to provide Customs with documentary evidence for four of the 16 items. As a result, the duty free treatment for four items was denied.

It was determined that CI did not review the shipments to determine whether they qualified for IFTA preference. The broker was instructed to enter the goods as eligible for IFTA. In addition, the 48 percent of IFTA value that was not covered in the PAS testing included two vendors that were never selected for review, and additional items for the two vendors that previously failed to provide IFTA documentary evidence. CI did not agree with our findings, was unable to quantify the loss of revenue, and did not take corrective actions to ensure that the 48 percent of merchandise value not tested qualified for IFTA. As a result, the PAS team proceeded to ACT to determine potential loss of revenue on ineligible IFTA merchandise.

*Example D: Situation in which the team would proceed to ACT (Compliance).*

CI has the same controls as Example A above except that prior to limited PAS testing, it was discovered that written internal control procedures were not followed. CI did not follow its procedures to review merchandise for IFTA eligibility. The broker was instructed to enter the goods as eligible for IFTA.

For this example, CI is a mass merchandiser of Middle Eastern goods. CI imports from many vendors covering many HTS numbers. Due to the large volume of IFTA vendors and the broad range of IFTA merchandise, a determination of risk could not be assessed, based on a limited review of 20 items, without going to the ACT phase. Since the company did not agree to, or want to, take corrective action, proceeding to ACT to determine CI level of compliance was considered necessary.

### Worksheet for Evaluating Internal Control Over Israel Free Trade Area Goods

Objective: Determine whether the company has procedures designed to effectively control Customs risks related to merchandise entered under provisions of IFTA.

**Risk Determination:**

**Acceptable**

**Unacceptable**

Internal Control	Yes	No	Not Applicable	Internal Control Manual Page Number	Work Paper Reference	Comments
<b>Overall Controls</b>						
Are internal controls over IFTA merchandise formally documented?						
Are written policies and procedures approved by management?						
Are written policies and procedures reviewed and updated periodically?						
Is one manager responsible for control of the Import Department, including IFTA imports?						
Does that manager have knowledge of Customs matters and the authority to ensure that internal control procedures for imports are established and followed by all company departments?						
Does the responsible person have cost accounting knowledge?						

Internal Control	Yes	No	Not Applicable	Internal Control Manual Page Number	Work Paper Reference	Comments
Do written internal control procedures assign IFTA duties and tasks to a position rather than a person?						
Does the company have good interdepartmental communication about IFTA matters?						
Does the company conduct and document periodic reviews of IFTA?						
Does the company use the IFTA periodic review results to make corrections to its import operations?						
Does the company use the IFTA periodic reviews to make changes to its import declarations as appropriate?						
Do internal controls involve a verification process to determine that the imported merchandise qualifies for IFTA?						
Is adequate descriptive information provided (by Purchasing, Engineering, other departments, and suppliers) to the Import Department and/or broker to ensure proper IFTA eligibility?						
Does the importer have procedures to obtain any required or necessary documentation to support the claim (e.g. a contract penalty provision if IFTA information is not provided to Customs on demand)?						

Internal Control	Yes	No	Not Applicable	Internal Control Manual Page Number	Work Paper Reference	Comments
Does the importer maintain an IFTA database or listing of imported merchandise that would readily identify IFTA transactions?						
Does the importer (or the importer's agent) visit the plant in the IFTA country(s) where the products are produced?						
Does the company perform an annual review of changes to IFTA?						
<b>New IFTA Merchandise</b>						
Does management review the classification and eligibility of new IFTA items?						
Is responsibility for the IFTA eligibility process assigned to one knowledgeable individual or department with management oversight?						
Is adequate descriptive information to ensure proper classification provided to the Import Department and/or broker by suppliers, engineers, purchasing department, etc.?						
Is Customs assistance sought in classifying merchandise (e.g., requesting binding rulings)?						
<b>Entry Review</b>						

Internal Control	Yes	No	Not Applicable	Internal Control Manual Page Number	Work Paper Reference	Comments
Does the company review entries to verify that correct classifications were used?						
Does the company monitor the entry review process to verify that controls were followed?						
Are suppliers required to print company provided HTSUS numbers on invoices and/or packing lists?						
Does the individual reviewing merchandise have adequate knowledge and training on IFTA issues?						
<b>Broker Oversight</b>						
Are HTS classifications for IFTA maintained in a database that is provided to brokers?						
Are brokers required to have written company approval to make classification changes?						
Does the company provide adequate broker oversight?						
<b>Internal Control Conclusions</b>						
Did PAS testing verify that control procedures were being followed?						
Did interviews with responsible persons support control procedures?						

<b>Internal Control</b>	<b>Yes</b>	<b>No</b>	<b>Not Applicable</b>	<b>Internal Control Manual Page Number</b>	<b>Work Paper Reference</b>	<b>Comments</b>
Does the company have internal control to address specific issues identified in the profile?						
<b>List company-specific procedures and controls below (if applicable)</b>						